

Message Text

PAGE 01 NATO 01703 01 OF 05 272138Z

67

ACTION EUR-12

INFO OCT-01 ISO-00 CIAE-00 PM-03 INR-07 L-02 ACDA-05

NSAE-00 PA-01 PRS-01 SP-02 USIA-06 TRSE-00 SAJ-01

AID-05 COME-00 EB-07 FRB-03 XMB-02 OPIC-03 CIEP-01

LAB-04 SIL-01 OMB-01 DODE-00 SS-15 NSC-05 FEA-01

INT-05 OES-03 GSA-01 STR-04 /102 W

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P R 271710Z MAR 75

FM USMISSION NATO

TO SECSTATE WASHDC PRIORITY 872

INFO ALL NATO CAPITALS 5181

USMISSION OECD PARIS

USMISSION EC BRUSSELS

C O N F I D E N T I A L SECTION 1 OF 5 USNATO 1703

E.O. 11652: GDS

TAGS: PFOR, ECON, NATO

SUBJECT: ECONADS: PAPER ON STRATEGIC AND POLITICAL IMPLICATIONS
OF ECONOMIC SITUATION

REF: USNATO 1647

1. MISSION TRANSMITTED BY SEPTTEL REVISED TEXT OF FIRST 12
PARAGRAPHS OF STUDY ON STRATEGIC AND POLITICAL IMPLICATIONS OF ECONO-
MIC SITUATION. FOLLOWING IS REVISED UPDATED TEXT OF REMAINING
PARAGRAPHS ON ECONOMIC OUTLOOK FOR NATO AND WARSAW PACT,
EXCEPT FOR PARAS 18 AND 19 FOR WHICH US REQUESTED TO SUPPLY
REVISED TEXT (REFTEL). IF DEPARTMENT HAS ADDITIONAL COMMENTS
THEY SHOULD REACH USNATO IN TIME FOR FINAL REVIEW IN ECONOMIC
COMMITTEE APRIL 7, BEARING IN MIND THERE WILL BE OPPORTUNITY
FOR FURTHER REVISION BY US AND OTHER ALLIES IN SUBSEQUENT
DISCUSSION IN SPC.

2. REVISED, UPDATED TEXT IS AS FOLLOWS:

QUOTE:

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PAGE 02 NATO 01703 01 OF 05 272138Z

THE ECONOMIC OUTLOOK FOR NATO

13. ECONOMIC GROWTH. THE RATE OF ECONOMIC GROWTH DROPPED
CONSIDERABLY IN MOST MEMBER COUNTRIES IN 1974, AND IN SOME REAL

DECLINE WAS RECORDED. FOR 1975 AS A WHOLE A FURTHER DETERIORATION OF THE ECONOMIC CLIMATE IS FORESEEN. ALTHOUGH MEASURES WILL BE TAKEN IN 1975 TO INCREASE OUTPUT, IT IS UNLIKELY THAT AN IMPROVEMENT IN RATES OF GROWTH COULD BE ACHIEVED UNTIL THE LATTER PART OF 1975, EVEN UNDER OPTIMISTIC ASSUMPTIONS. BY THE END OF 1975, AN ADJUSTMENT TO THE CHANGED ENERGY SITUATION WILL PROBABLY HAVE BEEN MADE, AND RECOVERY WILL BE FELT IN SOME SECTORS.

14. WHILE THE PROJECTED RATES OF GROWTH ARE BELOW THE TRENDS IN THE 1960S FOR MOST COUNTRIES, SOME ARE MORE SERIOUSLY AFFECTED THAN OTHERS. IN PARTICULAR THE UNITED STATES' ECONOMY, WHICH REPRESENTS ABOUT ONE-HALF OF THE OUTPUT OF NATO AS A WHOLE, EXPERIENCED A DECLINE OF 2.2PCT IN REAL GNP IN 1974 AND A FURTHER DECLINE OF 4.5 PCT IS FORESEEN IN 1975. CANADA, FRANCE AND ITALY, WITH RELATIVELY HIGH RATES OF GROWTH IN 1974 (BETWEEN 3.7 AND 4.5 PCT), WILL SHOW CONSIDERABLY LOWER GROWTH RATES IN 1975. FOR ITALY A DECLINE IS FORECAST. GERMANY, WHICH HAS EMPHASIZED CONTROL OF INFLATION IN ITS POLICY CHOICES, GREW BY ONLY 0.4 PCT IN 1974 AND ONLY A MARGINAL IMPROVEMENT IS EXPECTED IN 1975 AS A RESULT OF A MODEST EXPANSION IN PRIVATE CONSUMPTION. THE UNITED KINGDOM'S ECONOMIC GROWTH RATE WAS NEGATIVE IN 1974. A SLIGHT IMPROVEMENT HAS BEEN FORECAST FOR 1975. UNEMPLOYMENT RATES IN ALL COUNTRIES ARE HIGHER THAN IN RECENT YEARS AND FURTHER DETERIORATION OF THE SITUATION COULD CAUSE SERIOUS SOCIAL AND POLITICAL PROBLEMS AND HAVE CUMULATIVE EFFECTS ON THE ECONOMY. WITH UNEMPLOYMENT EMERGING AS ANOTHER PRIMARY PROBLEM, GOVERNMENTS MIGHT CHANGE THEIR ECONOMIC POLICIES AND REFLATE IN ORDER TO REDUCE UNEMPLOYMENT BEFORE THE INFLATIONARY PROBLEM HAS BEEN SOLVED.

INFLATION

15. RATES OF INFLATION ARE EXPECTED TO REMAIN HIGH. FOR NATO AS A WHOLE, CONSUMER PRICES IN 1974 WERE 13.5(1) PERCENT ABOVE 1973, AND WITH ONLY MODEST REDUCTION IN THE RATE OF INCREASE EXPECTED IN 1975. GOVERNMENT STABILIZATION PROGRAMS MAY IMPROVE

PAGE 03 NATO 01703 01 OF 05 272138Z

ON THE FORESEEN PERFORMANCE, BUT EFFORTS TO CONTROL INFLATION HAVE MET WITH LITTLE SUCCESS TO DATE, AND STRONG RECESSIONARY TENDENCIES IN MOST COUNTRIES WILL LIMIT THE ABILITY OF GOVERNMENTS TO TAKE STRONG ANTI-INFLATIONARY MEASURES. SOME COUNTRIES HAVE BEEN MORE SUCCESSFUL THAN OTHERS IN CONTAINING INFLATION; GERMANY HAS KEPT PRICE INCREASES DOWN TO ABOUT 7.0 PERCENT, WHILE ITALY, THE UK AND FRANCE HAVE SUFFERED RELATIVELY HIGH RATES. IN PART, THIS IS BECAUSE OF DIFFERENCES IN VIEWS AS TO THE DESIRABILITY, OR THE POLITICAL ABILITY TO HOLD THE LINE ON PRICES IF INCREASED UNEMPLOYMENT AND A LOWER RATE OF GROWTH IS THE COST OF DOING SO. THE SOCIAL INEQUITIES WHICH ARE INHERENT IN INFLATIONARY CONDITIONS MAY LEAD TO DOMESTIC INSTABILITY WHICH COULD ENDANGER THE SECURITY OF THE ALLIANCE. GOVERNMENTS MAY LOOK INCREASINGLY FOR POLICIES WHICH COULD

COMPENSATE FOR THE DISTORTION BROUGHT ABOUT BY INFLATION IF STABILIZATION POLICIES CANNOT SUCCEED WITHOUT A PROLONGED AND SEVERE RECESSION.

INTERNATIONAL PAYMENTS

16. DURING 1974, NATO MEMBERS HAVE A RUN A COMBINED DEFICIT OF THEIR CURRENT ACCOUNTS OF APPROXIMATELY \$19 BILLION; THIS IS EXPECTED TO DECREASE IN 1975 TO ABOUT \$13 BILLION. THE MAJOR CAUSE OF THESE DEFICITS IS THE INCREASE IN THE COST OF IMPORTED OIL, WHICH IS NOT OFFSET BY INCREASED EXPORTS. THE INCREASE IN THE OIL BILL ALONE FOR NATO MEMBERS WAS \$45 BILLION IN 1974. IN 1975 IT IS EXPECTED TO RISE TO ABOUT \$48 BILLION. WITHIN NATO, GERMANY, BELGIUM/LUXEMBOURG AND THE NETHERLANDS ARE EXPECTED TO RUN CURRENT ACCOUNT SURPLUSES.

(1) WITH ICELAND INCLUDED THE FIGURE IS ABOUT 16.5 PCT

17. THE QUESTION OF ENSURING ADEQUATE FINANCING FOR THE MOST EXPOSED COUNTRIES IS ONE OF THE CRITICAL ISSUES FACING THE OIL-IMPORTING COUNTRIES IN THE MEDIUM-TERM. IN 1974 THE DEFICITS OF THE MAJOR INDUSTRIAL COUNTRIES TAKEN AS A WHOLE WAS TO A LARGE EXTENT SELF-FINANCING, SINCE THE OIL PRODUCING COUNTRIES HAD LITTLE CHOICE BUT TO INVEST THEIR SURPLUS EARNINGS IN THE ESTABLISHED CAPITAL MARKETS. HOWEVER, THE PREFERENCE OF THE OIL-
CONFIDENTIAL

PAGE 04 NATO 01703 01 OF 05 272138Z

PRODUCERS FOR SECURE, LIQUID ASSETS, AND THE SHEER VOLUME OF THE FUNDS INVOLVED, MEAN THAT THE RESULTING PATTERNS OF CAPITAL FLOWS MIGHT NOT MEET THE NEEDS OF MANY SMALLER COUNTRIES. TO DATE, MAJOR DEFICIT COUNTRIES HAVE NOT SIGNIFICANTLY DRAWN DOWN THEIR RESERVES, PREFERRING TO BORROW THE NECESSARY FOREIGN EXCHANGE; THUS RESERVES STILL PROVIDE A CUSHION WHICH CAN BE USED IF NECESSARY. BALANCE OF PAYMENTS PROBLEMS ARE MOST ACUTE FOR THE LESS INDUSTRIALISED COUNTRIES OF THE ALLIANCE. THE PRESENT ECONOMIC SLOWDOWN CONSTRAINS THE GROWTH OF THEIR EXPORTS AND CAUSES A DECLINE IN TRADITIONAL EARNINGS SUCH AS TRANSFERS FROM NATIONALS EMPLOYED ABROAD AND TOURISM AND SHIPPING. RISING IMPORT PRICES HAVE ADDED TO THE DIFFICULTIES OF THOSE COUNTRIES. THE RECENT AGREEMENT ON THE ESTABLISHMENT OF A FUND OPEN TO ALL MEMBERS OF THE OECD WILL SERVE AS A SAFETY NET FOR MEMBER COUNTRIES IF THEY RUN INTO SERIOUS BALANCE OF PAYMENTS DIFFICULTIES AS A RESULT OF HIGHER OIL PRICES OR OTHER FACTORS BEYOND THEIR CONTROL. THIS FUND IS ALMOST CERTAIN TO HAVE GREATER PRACTICAL EFFECT FOR NATO MEMBER COUNTRIES THEN THE SPECIAL IMF FACILITY.

CONFIDENTIAL

PAGE 01 NATO 01703 02 OF 05 272243Z

67

ACTION EUR-12

INFO OCT-01 ISO-00 CIAE-00 PM-03 INR-07 L-02 ACDA-05

NSAE-00 PA-01 PRS-01 SP-02 USIA-06 TRSE-00 SAJ-01

AID-05 COME-00 EB-07 FRB-03 XMB-02 OPIC-03 CIEP-01

LAB-04 SIL-01 OMB-01 DODE-00 SS-15 NSC-05 FEA-01

INT-05 OES-03 GSA-01 STR-04 /102 W

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P R 271710Z MAR 75

FM USMISSION NATO

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INFO ALL NATO CAPITALS 5182

USMISSION OECD PARIS

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C O N F I D E N T I A L SECTION 2 OF 5 USNATO 1703

18. AND 19. NEW US DRAFT

20. DECISIONS ON THE ALLOCATION OF AVAILABLE FISCAL RESOURCES TO ANY GIVEN PROGRAM, SUCH AS DEFENSE EXPENDITURES, MUST TAKE INTO ACCOUNT COMPETING USES OF THESE LIMITED RESOURCES. THERE IS EVIDENCE THAT DEFENSE EXPENDITURES ARE BEING GIVEN A LOWER PRIORITY IN BUDGET DECISIONS; THE SHARE GOING FOR DEFENSE BUDGETS HAS BEEN DECLINING IN RECENT YEARS FOR MOST COUNTRIES BOTH AS A PERCENTAGE OF GNP AND OF TOTAL GOVERNMENT EXPENDITURES. THIS IS BELIEVED TO RESULT IN PART FROM DOMESTIC PRESSURES WHICH HAVE BEEN INTENSIFIED BY THE DETERIORATION OF THE ECONOMIC SITUATION; THESE PRESSURES REQUIRE THE GOVERNMENTS TO DEVOTE GREATER EXPENDITURES TO UNEMPLOYMENT COMPENSATION AND TO PROGRAMS DESIGNED TO REDUCE THE IMPACT OF INFLATION ON LOWER INCOME GROUPS. THE RELUCTANCE TO INCLUDE DEFENSE EXPENDITURES AMONG THE FIRST PRIORITY MAY ALSO BE DUE IN PART TO PSYCHOLOGICAL FACTORS, INCLUDING A DECLINE IN THE PUBLIC SENSE OF URGENCY IN MAINTAINING A STRONG DEFENSE POSTURE AS RELATIONS BETWEEN EAST AND WEST HAVE IMPROVED IN RECENT YEARS.

CONFIDENTIAL

PAGE 02 NATO 01703 02 OF 05 272243Z

STRATEGIC RESOURCES

21. EVENTS OF LAST WINTER POINT UP THE IMPORTANCE OF IMPORTED OIL TO NATO ALTHOUGH THE US MEETS A LARGE PART OF ITS OWN REQUIREMENTS, IT STILL IMPORTS ABOUT 40 PCT OF THE OIL IT USES. THE EUROPEAN COUNTRIES DEPEND ON IMPORTS FOR 97 PERCENT OF THEIR OIL NEEDS, ALTHOUGH THIS WILL CHANGE AS THE NORTH

SEA DEPOSITS ARE MORE FULLY EXPLOITED AND AS A CONSEQUENCE OF THE EEC ENERGY CONSERVATION PROGRAMME AND OF EFFORTS TO DEVELOP OTHER ENERGY SOURCES. WHILE MOST US IMPORTS COME FROM THE WESTERN HEMISPHERE, PARTICULARLY CANADA, WESTERN EUROPE NOW DEPENDS HEAVILY ON SOURCES OF PURCHASE IN THE MIDDLE EAST. REDUCED CONSUMPTION AND CO-OPERATIVE SUPPLY AGREEMENTS UNDER THE IEA CAN CUSHION SOME OF THE PROBLEMS WHICH WERE GENERATED BY THE OIL CRISIS.

22. ONLY A FEW OF THE MAJOR NON-FUEL MINERALS OFFER EXPORTERS SUFFICIENT LEVERAGE (BY VIRTUE OF CONCENTRATION OF PRODUCTION, INELASTICITY OF SUPPLY, AND IMPORT DEPENDENCE) FOR CARTER-LIKE ACTION. US DEPENDENCE ON IMPORTS OF RAW MATERIALS OTHER THAN OIL IS MODEST, ABOUT 15 PERCENT OF CONSUMPTION. WESTERN EUROPE, ON THE OTHER HAND, IMPORTS 75 PERCENT OF ITS RAW MATERIAL NEEDS, A SUBSTANTIAL PART OF THIS FROM LDCS. A STUDY BY THE EC CONCLUDED THAT WHILE THERE IS NO IMMEDIATE PROBLEM FOR RAW MATERIALS SUPPLIES, FIVE NON-PETROLEUM MATERIALS ARE SUSCEPTIBLE TO POTENTIAL SUPPLY DISRUPTION: CHROMIUM, COPPER, PHOSPHATES, TUNGSTEN AND URANIUM.

23. FOR ALL NATO MEMBERS, CONTINUING ACCESS TO LDC RAW MATERIALS WILL REQUIRE DEALING WITH THE ASSUMPTION BY LDCS OF GREATER CONTROL OF PRODUCTION AND PROCESSING ON THEIR TERRITORIES.

24. NATO AS A WHOLE WOULD HAVE NO DIFFICULTY MEETING ITS FOOD SUPPLY NEEDS, SINCE THE US AND CANADA ARE MAJOR EXPORTERS OF MOST BASIC FOODSTUFFS AND THE EEC IS ITSELF AN IMPORTANT PRODUCER. DISRUPTIONS IN SHIPPING IN THE CASE OF CRISES IN THE MEDITERRANEAN AREA COULD POSE SOME SUPPLY PROBLEMS FOR WESTERN EUROPE, HOWEVER.

THE ECONOMIC OUTLOOK FOR THE WARSAW PACT(1)
CONFIDENTIAL

PAGE 03 NATO 01703 02 OF 05 272243Z

25. THE DRAMATIC PRICE INCREASES IN RAW MATERIALS, PARTICULARLY ENERGY, OF THE LAST YEAR OR SO HAVE BENEFITED THE SOVIET BALANCE OF PAYMENTS. AT THE SAME TIME THE GENERAL SOVIET LEVEL OF SELF-CONTAINMENT, ITS RELATIVE DOMESTIC INSULATION FROM EXTERNAL MARKETS, THE CONTROL EXERCISED BY PLANNING AUTHORITIES AND MINIMAL USE OF PRICES TO INFLUENCE ALLOCATION OF RESOURCES HAVE ACTED TO MINIMIZE THE IMPACT OF WESTERN INFLATION UPON THE SOVIET UNION. ALTHOUGH THE SOVIETS HAVE BEEN BUYING SUBSTANTIAL QUANTITIES OF GRAIN AT HIGH PRICES, OVERALL THE SOVIET ECONOMY HAS NOT SUFFERED AND MAY EVEN HAVE BEEN STRENGTHENED BY RECENT ECONOMIC TRENDS.

26. THE SOVIET UNION'S EUROPEAN ALLIES IN GENERAL DO NOT HAVE ITS NATURAL RESOURCES. FAR MORE RELIANT ON IMPORTS FROM THE WEST AND DEFICIENT IN ENERGY, THE EAST EUROPEAN ECONOMIES ARE POTENTIALLY VULNERABLE TO ADVERSE BALANCE OF PAYMENTS EFFECTS, DUE TO FUEL AND INFLATION. SO FAR THESE HAVE MOSTLY BEEN AVOIDED

BECAUSE OF LONG-TERM OIL CONTRACTS WITH THE SOVIET UNION AND INTERNAL RESTRICTIVE MEASURES. IN THE FUTURE, HOWEVER, THE SITUATION WILL PROBABLY CHANGE CONSIDERABLY IN INTRA-COMECON TRADE. RECENT AGREEMENTS COVERING THE YEARS THROUGH 1980 REPORTEDLY STIPULATE SUBSTANTIAL REISES IN PRICES PAID BY EASTERN EUROPE FOR SOVIET RAW MATERIALS AND OIL, WITH OIL PRICES INCREASING MORE THAN 100 PCT. SUCH EXTRA COSTS WOULD STILL BE CONSIDERABLY LESS THAN THE PRICE RISES PAYABLE BY NATO COUNTRIES ON WORLD MARKETS SINCE 1973 AND WOULD ALSO BE MITIGATED BY LESSER INCREASES IN PRICES OF SOME EAST EUROPEAN EXPORTS TO BOTH THE USSR AND THE WEST. MOREOVER, POLAD OBTAINS A TRADE BENEFIT FROM ITS COAL SALES TO WEST EUROPE AND RUMANIA CONTINUES TO BE LARGELY ENERGY-INDEPENDENT.

(1) ANY STUDY OF THE WARSAW PACT ECONOMY AS A WHOLE WOULD REFLECT SOVIET TRENDS PRIMARILY, SINCE THE SOVIET UNION'S GNP IS NEARLY TEN TIMES THAT OF POLAND, THE NEXT LARGEST COUNTRY, AND NEARLY THREE TIMES THAT OF ALL ITS EAST EUROPEAN ALLIES. AGGREGATES WOULD THUS OBSCURE TRENDS IN EASTERN EUROPE

27. OF MORE IMMEDIATE POTENTIAL DIFFICULTY TO EAST EUROPE
CONFIDENTIAL

PAGE 04 NATO 01703 02 OF 05 272243Z

IS THE SPEED, AT WHICH HARD CURRENCY IMPORTS, AND PURCHASES NOT YET TRANSLATED INTO IMPORTS, INCREASED DURING THE LAST TWO YEARS. MOST COUNTRIES HAVE BEEN STRAINING THEIR FINANCING ABILITY AND ARE NOT WELL-SITUATED TO SUSTAIN BALANCE OF PAYMENTS SHOCKS, WHICH WILL BECOME MORE SEVERE AFTER 1975, AS A RESULT OF HIGH FUEL PRICES. BALANCE OF PAYMENTS RESTRAINTS WILL FORCE THEM TO REARRANGE PRIORITIES AND TO STRETCH OUT THEIR INDUSTRIALIZATION AND CONSUMER WELFARE PROGRAMS. THE HIGHER ENERGY AND MATERIALS PRICES PAYABLE TO THE USSR ALSO SEEM TO BE FORCING ADDITIONAL SHIFTS IN TRADE PATTERNS.

SOVIET SITUATION AND PROJECTIONS

CONFIDENTIAL

PAGE 01 NATO 01703 03 OF 05 272302Z

67
ACTION EUR-12

INFO OCT-01 ISO-00 CIAE-00 PM-03 INR-07 L-02 ACDA-05

NSAE-00 PA-01 PRS-01 SP-02 USIA-06 TRSE-00 SAJ-01

AID-05 COME-00 EB-07 FRB-03 XMB-02 OPIC-03 CIEP-01

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INT-05 OES-03 GSA-01 STR-04 /102 W

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P R 271710Z MAR 75

FM USMISSION NATO

TO SECSTATE WASHDC PRIORITY 874

INFO ALL NATO CAPITALS 5183

USMISSION OECD PARIS

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C O N F I D E N T I A L SECTION 3 OF 5 USNATO 1703

28. THE SOVIET TRADE BALANCE WITH OECD COUNTRIES TURNED FROM A LONG TIME PATTERN OF DEFICITS INTO A SURPLUS OF \$1 BILLION OR MORE IN 1974. OTHER ADVANCE ESTIMATES BASED ON OECD FIGURES INDICATE A NEAR BALANCE IN SOVIET COMMERCE WITH NATO COUNTRIES AND A SURPLUS OF ABOUT \$1.2 BILLION IN TRADE WITH OECD COUNTRIES.) THE USSR OF ABOUT \$1.2 BILLION IN TRADE WITH OECD COUNTRIES.) THE USSR WILL PROBABLY CONTINUE TO EARN ADEQUATE FOREIGN EXCHANGE TO PAY FOR GOODS IT PLANS TO OBTAIN FROM THE WEST FOR AT LEAST THE NEXT FEW YEARS. HIGH PRICES FOR OIL, NATURAL GAS AND OTHER MAJOR SOVIET EXPORTS, AND A RAPID EXPANSION IN THE VOLUME OF SOVIET EXPORTS OF GAS SHOULD INCREASE HARD CURRENCY EARNINGS. GOLD PRICES HAVE ALSO RISEN CONSIDERABLY IN RECENT YEARS AND THE USSR, A MAJOR GOLD PRODUCER, HAS PROFITED THEREBY, REPORTEDLY EARNING \$500 MILLION FROM BULLION SALES IN 1974.

29. WE BELIEVE THE SOVIETS SHOULD TAKE ADVANTAGE OF THE NEW STRENGTH IN THEIR BALANCE OF PAYMENTS (AND THE WEST EUROPEAN DESIRE TO EXPORT MORE) TO INCREASE IMPORTS USING EARNINGS TO THE FULLEST FOR IMMEDIATE PURCHASES. THIS ESTIMATE OF SOVIET INTENTIONS TO SPEND IS BASED ON TRENDS, CONTINUOUS SINCE THE MID-1960S, OF INCREASING SOVIET HARD CURRENCY IMPORTS OF MODERNIZING AND INCREMENTAL TECHNOLOGY, INCLUDING FINISHED GOODS. AN EXAMINATION OF SOVIET AGRICULTURAL IMPORTS AND PURCHASE AGREEMENTS ALSO YIELDS EVIDENCE OF SOVIET DETERMINATION TO SECURE HIGH DOMESTIC MEAT AVAILABILITIES.

PAGE 02 NATO 01703 03 OF 05 272302Z

30. THESE IMPORT PATTERNS WERE INITIATED WHEN THE SOVIET EXTERNAL ECONOMIC SITUATION WAS NOT AS FAVORABLE AS TODAY. SOVIET SHOPPING FOR EXPENSIVE PROJECTS HAS INTENSIFIED IN RECENT YEARS, WITH NEW ORDERS FOR WESTERN PLANT AND EQUIPMENT TRIPLING BETWEEN 1971 AND 1974.

31. SOVIET DECISIONS TO STRENGTHEN THE ECONOMY AND CONSUMER WELFARE HAVE TO SOME EXTENT BEEN BASED ON OBTAINING SUBSTANTIAL WESTERN CREDITS. WITH AN IMPROVED BALANCE OF PAYMENTS THE SOVIETS MAY SEEK LOANS FOR MAJOR IMPORT PROJECTS WHEN IT SUITS THEIR POLITICAL AND ECONOMIC INTERESTS AND CONTINUE TO TRY TO OBTAIN

WESTERN AGREEMENT TO PRODUCT PAYBACK ARRANGEMENTS, WHICH SHIFT SOME OF THE DEVELOPMENTAL RESPONSIBILITY TO WESTERN INTERESTS.

32. ALTERNATIVE CHOICES ARE AVAILABLE TO THE SOVIETS FOR USE OF THEIR GROWING FUNDS. THEY MAY STERILIZE SOME EXCHANGE EARNINGS BY INCREASING RESERVES OR DEFER THEIR OWN ACCESS BY ASSISTING THEIR ALLIES. THE DOMINANT USE IN THE NEXT FEW YEARS WILL PROBABLY BE TO HASTEN SOVIET GROWTH AND STRENGTHEN THE ECONOMY. SIBERIAN DEVELOPMENT WILL HAVE A HIGH PRIORITY BUT IN THIS AREA ONLY A FEW SIBERIAN INVESTMENTS WILL YIELD IMMEDIATE NET RETURNS TO THE SOVIET ECONOMY AND IMPROVE THE BALANCE OF PAYMENTS. IN ADDITION, A MOUTING PACE OF DOMESTIC INVESTMENT COULD DEVELOP NEW CONSTRAINTS IN THE FORM OF POSSIBLE SHORTAGES OR INSUFFICIENT MOBILITY OF APPROPRIATE LABOR, ARISING OUT OF THE LIMITATIONS OF INDIGENOUS RESOURCES OF SKILLS, AND THE NATURE OF THE SOVIET ECONOMIC SYSTEM. WHILE THE DEMAND OF SOVIET ENTERPRISES FOR MANPOWER HAS BEEN FOUND TO BE EXCESSIVE, INDIVIDUAL BRANCHES OF THE ECONOMY AND INDUSTRY ARE DISTINCTLY SHORT OF LABOR POWER, AS ARE CERTAIN REGIONS AND OCCUPATIONS.

33. IN REGARD TO THE MILITARY SECTOR, IT IS WELL KNOWN THAT THE SOVIET PLAN GIVES IT THE HIGHEST PRIORITY IN ALL RESOURCE
CONFIDENTIAL

PAGE 03 NATO 01703 03 OF 05 272302Z

ALLOCATIONS. SINCE 1960 TOTAL SOVIET DEFENSE SPENDING IN REAL TERMS-INCLUDING SPACE AND MILITARY RESEARCH AND DEVELOPMENT-HAS BEEN INCREASING AT ABOUT 3 PERCENT A YEAR. DURING 1974 TOTAL OUTLAYS WERE ESTIMATED TO HAVE BEEN IN THE RANGE OF 27 TO 32 BILLION RUBLES.

34. FOLLOWING TWO YEARS WITHOUT GROWTH IN THE EARLY SEVENTIES, SOVIET DEFENSE SPENDING ENTERED AN EXPANSIONARY PHASE IN 1973 WHICH IS EXPECTED TO LAST THROUGH 1976. DURING THIS PERIOD DEFENSE OUTLAYS ARE EXPECTED TO GROW ABOUT 4 TO 5 PERCENT A YEAR. PRESENT PROJECTIONS SHOW DEFENSE EXPENDITURES DEVELLING OFF IN THE LATE 1970S SO THAT FOR THE DECADE AS A WHOLE SPENDING IS EXPECTED TO CONTINUE TO INCREASE AT THE HISTORICAL AVERAGE OF ABOUT 3 PERCENT A YEAR.

EAST EUROPE

35. WITH RESPECT TO ENERGY, ALL EAST EUROPEAN COUNTRIES EXCEPT RUMANIA HAVE DEPENDED AND STILL DEPEND ON THE USSR FOR MOST OF THEIR OIL NEEDS, IN ADDITION TO OTHER ENERGY SUCH AS NATURAL GAS AND DIRECT TRANSMISSION OF ELECTRICITY, AND OTHER RESOURCES. POLAND, WITH LARGE COAL DEPOSITS, RELIES TO A LESSER EXTENT ON OIL AND IS REAPING SUBSTANTIAL HARD CURRENCY FROM THIS SUDDENLY DESIRABLE EXPORT, ALTHOUGH BECAUSE OF LARGE INVESTMENT PROGRAMS WITH A HIGH IMPORT CONTENT, ITS TRADE DEFICIT IN RECENT YEARS HAS BEEN LARGE-ON THE ORDER OF \$3.2 BILLION FOR 1973/4.

36. RESPONDING TO EARLIER SOVIET URGING TO REDUCE THEIR DEPENDENCE ON SOVIET OIL, EAST EUROPEAN COUNTRIES HAVE SOUGHT AGREEMENTS WITH VARIOUS OTHER SUPPLIERS; AMOUNTS AND PRICES OF SOVIET OIL DELIVERED IN THE PAST WERE COMMITTEED IN TRADE AGREEMENTS THAT EXPIRE THIS YEAR OR NEXT. FOR THE FUTURE, RECENT AGREEMENTS REPORTEDLY BASE THE SOVIET PRICE THROUGH 1980 ON A MOVING AVERAGE OF PAST WESTERN OIL PRICES; THIS STANDARD WILL IMMEDIATELY BOOST SOVIET OIL PRICES MORE THAN 100 PCT OVER THEIR 1973 LEVEL-A RISE STILL CONSIDERABLY LESS THAN THE FOURFOLD OIL PRICE INCREASE ON WORLD MARKETS. SOVIET COMMITMENTS ON QUANTITIES WILL PROBABLY ALSO EXPAND, PERHAPS REACHING 70 MILLION TONS IN 1980 (A 30 PCT INCREASE OVER THE 1973 LEVEL). NEVERTHELESS, THE SOVIETS WILL NOT COVER FULLY THE GROWING NEEDS OF THE
CONFIDENTIAL

PAGE 04 NATO 01703 03 OF 05 272302Z

EAST RUROPEAN ECONOMIES. THE PORTION TO BE COVERED AND THE TERMS WHICH WILL PREVAIL HAVE NOT YET BEEN AUTHORITATIVELY ANNOUNCED.

CONFIDENTIAL

PAGE 01 NATO 01703 04 OF 05 272319Z

67
ACTION EUR-12

INFO OCT-01 ISO-00 CIAE-00 PM-03 INR-07 L-02 ACDA-05

NSAE-00 PA-01 PRS-01 SP-02 USIA-06 TRSE-00 SAJ-01

AID-05 COME-00 EB-07 FRB-03 XMB-02 OPIC-03 CIEP-01

LAB-04 SIL-01 OMB-01 DODE-00 SS-15 NSC-05 FEA-01

INT-05 OES-03 GSA-01 STR-04 /102 W
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P R 271710Z MAR 75
FM USMISSION NATO
TO SECSTATE WASHDC PRIORITY 875
INFO ALL NATO CAPITALS 5184
USMISSION OECD PARIS
USMISSION EC BRUSSELS

C O N F I D E N T I A L SECTION 4 OF 5 USNATO 1703

37. THE GAS AND OIL PIPELINE NETWORKS, WHICH THE SOVIETS HAVE ESTABLISHED BETWEEN THEMSELVES AND BOTH EAST AND WEST EUROPE, AND WHICH ARE DUE TO EXPAND STILL FURTHER, PROVIDE AN IMPORTANT EXAMPLE OF INTER-RELATEDNESS. EAST EUROPEAN SUPPLIES COULD BE AUGMENTED BY THE SOVIETS ACTING AS ENERGY BROKER FOR SOME

EAST EUROPEAN COUNTRIES FOR EXAMPLE, BY OBTAINING NATURAL GAS FROM IRAN AND SELLING EQUIVALENT SUPPLIES TO EAST EUROPE OR BY FINANCING MIDDLE EAST SUPPLIES OF OIL FOR EASTERN EUROPE ON HER OWN ACCOUNT.

38. TO MEET THE INCREASED BILL FOR SOVIET OIL, THE EAST EUROPEANS WILL HAVE TO BOOST EXPORTS TO THE USSR SUBSTANTIALLY AND HAVE ALREADY CONTRACTED TO UNDERTAKE LONGER-TERM INVESTMENT IN SOVIET ENERGY DEVELOPMENT, E.G. THE ORENBURG NATURAL GAS PIPELINE. IN THE MEANTIME SELLING SUCCESSFULLY IN THE WEST, SUCH AS PROCESSED FOODS. THIS MAY REQUIRE EAST EUROPE TO CURTAIL ITS RAPIDLY RISING IMPORTS FROM THE WEST, WITH REPERCUSSIONS ON DOMESTIC OUTPUT AND CONSUMER WELFARE PROGRAMS.

CONFIDENTIAL

PAGE 02 NATO 01703 04 OF 05 272319Z

THE INCREASED COSTS OF OIL PURCHASED IN THE WEST WILL PROBABLY NOT HAVE A SERIOUS EFFECT ON EAST EUROPEAN PAYMENT BALANCES THROUGH 1975. WE ESTIMATE THAT THE INCREASE IN NET COSTS WILL LIE IN THE \$50 TO 165 MILLION RANGE. BUT BY 1980 EAST EUROPE'S INCREASED RELIANCE ON NON-SOVIET SOURCES MIGHT RAISE ITS OIL IMPORTS THEREFROM TO ABOUT 30 MILLION TONS OR (AT CURRENT PRICES) \$2.2 BILLION, ROUGHLY DOUBLE CURRENT LEVELS.

40. EASTERN EUROPE WOULD PROBABLY WELCOME NEW EURO-CURRENCY LOANS TO HELP PAY FOR OIL AND AT LEAST PARTIALLY MAINTAIN IMPORT TRENDS IN INDUSTRIAL GOODS. HOWEVER, THE DEBT LEVELS AND DEBT SERVICE RATIOS OF SEVERAL OF THE COUNTRIES ARE BECOMING QUITE HIGH. CONSEQUENTLY THE NEED TO INCREASE EXPORTS AND INCREASE INDEBTEDNESS FOR OIL WILL COME AT A BAD TIME FOR THESE COUNTRIES, COMPOUNDING PAYMENT PROBLEMS THAT WERE DEVELOPING BEFORE THE OIL CRISIS.

41. POLAND'S ECONOMIC PROBLEMS ARE AMELIORATED BY ITS COAL AVAILABILITIES, WHICH ARE HELPFUL TO THE DOMESTIC ECONOMY AND FOR WHICH IT HAS A HARD CURRENCY EXPORT MARKET. HOWEVER, IN SPITE OF GROWING COAL EARNINGS, POLAND RAN A HARD CURRENCY TRADE DEFICIT IN 1973 ALONE OF OVER ONE BILLION DOLLARS, LARGELY COVERED BY CREDITS. FOR 1974, THE DEFICIT PROBABLY EXCEEDED \$2 BILLION.

42. ROMANIA, ABLE IN THE PAST TO STRIKE A MORE INDEPENDENT POSE BECAUSE OF ITS OWN OIL CAPABILITIES, FINDS ITS ECONOMY UNDER PRESSURE FROM OTHER SOURCES. THE EXIGENCIES OF ITS INTENSE PACE OF INDUSTRIALIZATION, COUPLED WITH TWO BAD HARVESTS IN A ROW, MAY FORCE CUTBACKS IN ROMANIAN WESTERN TRADE, PARTICULARLY IF EXPORT CREDITS TAPER OFF AND RECESSION IS PROLONGED IN THE WEST.

43. WITH RESPECT TO INFLATION, EAST EUROPEAN COUNTRIES HAVE TRIED TO INSULATE DOMESTIC PRICES ADMINISTRATIVELY, AND DIRECTING MOST OF THEIR FOREIGN COMMERCE TO OTHER COMMUNIST COUNTRIES. THIS

CAN ONLY BE SUCCESSFUL IN MAINTAINING STABLE PRICES TO CONSUMERS AT THE EXPENSE OF GOVERNMENT BUDGETS. CONSIDERABLE EXCESS DEMAND RESULTS FROM SHORTFALLS IN OUTPUT THAT HOLD ITS GROWTH BELOW THAT OF MONEY WAGES. FOR INDUSTRIAL AND OTHER EQUIPMENT IMPORTS THAT ARE NOT INTENDED DIRECTLY FOR CONSUMERS, AND WHICH FREQUENTLY
CONFIDENTIAL

PAGE 03 NATO 01703 04 OF 05 272319Z

ARE CUSTOM DESIGNED SO THERE IS NO BASE PERIOD PRICE REFERENCE, HIGHER SUPPLY PRICES RESULT IN THE IMPORTATION OF FEWER GOODS FOR THE AVAILABLE FOREIGN EXCHANGE. THE RESULT IS A SLOWING EFFECT ON ECONOMIC GROWTH, THOUGH THIS IS MITIGATED TO SOME EXTENT BY ANOTHER EFFECT OF WESTERN INFLATION-THE HIGHER PRICES ENJOYED BY CERTAIN EAST EUROPEAN EXPORTS ON WORLD MARKETS.

44. EXCEPT IN HUNGARY (WHICH IS EXPERIMENTING WITH ECONOMIC REFORMS) AND POLAND, DOMESTIC RETAIL PRICES HAVE SHOWN LITTLE UPWARD MOVEMENT-AND CERTAINLY MUCH LESS THEN IN MOST WESTERN COUNTRIES. IN ADDITION, THE GOVERNMENTS HAVE ADOPTED A WIDE RANGE OF ECONOMY MEASURES INCLUDING CONSERVATION PROGRAMS, EMPHASIS ON DOMESTIC RESOURCES AND CURTAILMENT OF "NON-ESSENTIAL" IMPORTS.

45. THESE STEPS HAVE HELPED THE EAST EUROPEANS TO COPE WITH THEIR BALANCE OF PAYMENTS PROBLEMS. THE LATTER, HOWEVER, WILL BE EXACERBATED BY THE DETERIORATING TERMS OF TRADE ANTICIPATED AS A RESULT OF THE READJUSTMENT OF COMECON PRICES THIS YEAR OR IN 1976 WHEN THE NEW PLANS START. THIS ADDITIONAL BURDEN, TOGETHER WITH THE PROBABILITY THAT SOVIET SUPPLIES WILL NOT GROW IN PACE WITH EAST EUROPE'S INDUSTRIALIZATION EXPECTATIONS WILL PRESENT THE VARIOUS LEADERSHIPS WITH PERHAPS THEIR MOST DIFFICULT PLANNING PROBLEM SINCE POST-WORLD WAR II RECONSTRUCTION.

46. IN ORDER TO MINIMIZE CUTBACKS IN IMPORTS, EAST EUROPE WILL TRY TO OBTAIN SOVIET FINANCING IN THE FORM OF PROLONGED TRADE DEFICITS, BORROW FURTHER IN WESTERN MONEY MARKETS, AND ARRANGE ADDITIONAL BARTER DEALS WITH MIDDLE EASTERN COUNTRIES. NEVERTHELESS, PLANNERS WILL PROBABLY HAVE TO RESIGN THEMSELVES TO SLOWER ECONOMIC GROWTH RATES DURING THE REMAINDER OF THE DECADE. THE SECTORS HARDEST HIT BY CUTBACKS IN FUEL SUPPLIES WOULD BE CHEMICALS, METALLURGY, AGRICULTURE, AND FOOD PROCESSING. A SLOWER RATE OF PROGRESS IN PLANS FOR INCREASING CONSUMER WELFARE-INCLUDING A SLOWDOWN IN THE AUTO BOOM-IS ALMOST CERTAIN.

CONFIDENTIAL

PAGE 01 NATO 01703 05 OF 05 272305Z

67
ACTION EUR-12

INFO OCT-01 ISO-00 CIAE-00 PM-03 INR-07 L-02 ACDA-05

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AID-05 COME-00 EB-07 FRB-03 XMB-02 OPIC-03 CIEP-01

LAB-04 SIL-01 OMB-01 DODE-00 SS-15 NSC-05 FEA-01

INT-05 OES-03 GSA-01 STR-04 /102 W

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C O N F I D E N T I A L SECTION 5 OF 5 USNATO 1703

EVALUATION

47. WHILE THIS ANALYSIS INDICATES A RISE IN SOVIET ECONOMIC STRENGTH, WE BELIEVE THE SIGNIFICANCE OF THIS BE MAGNIFIED UNDULY IN COMPARISON WITH NATO BECAUSE SOVIET ECONOMIC GROWTH STARTS FROM A LOWER BASE. SOVIET GNP PER CAPITA, E.G. IS WELL BELOW THAT OF ALMOST EVERY NATO MEMBER: THE SOVIET UNION'S EAST EUROPEAN ALLIES ARE GENERALLY LOWER IN TERMS OF GNP PER CAPITA. CONSUMERS IN WARSAW PACT COUNTRIES HAVE TRADITIONALLY BEEN DEPRIVED OF SIGNIFICANT PARTS OF THEIR POTENTIAL WELL-BEING FOR THE SAKE OF MILITARY AND NATIONAL ECONOMIC DEVELOPMENT PROGRAMS.

48. OTHER MAJOR PROBLEMS IN THE EASTERN BLOC'S ECONOMY INCLUDE ITS STRUCTURE, DIFFERENT FROM WESTERN ECONOMIES AND SEEMINGLY MORE STABLE, BUT EXHIBITING WEAKNESSES NONE-THELESS. UNEVEN QUALITY OF MANUFACTURED PRODUCTS LOWERS THE COMPETITIVENESS OF INDUSTRIAL EXPORTS. SUCESSIONS OF ACCELERATIONS AND DECLINES, OR BOTTLENECKS, IN THE USE OF CAPITAL ARE NOT UNKNOWN. UNDER EMPLOYED LABOR, LOW PRODUCTIVITY AND THE CONFIDENTIAL

PAGE 02 NATO 01703 05 OF 05 272305Z

DRAW OF A BURDENSOME BUREAUCRACY RESTRICT THE DEVELOPMENT POTENTIAL. IN ALL THOSE COUNTRIES AGRICULTURE FORMS A MORE SIGNIFICANT PORTION OF THE GNP THAN IN THE WEST AND IS A DRAIN ON THE LABOR FORCE.

49. LIKE THE SOVIET UNION, EAST EUROPEAN ECONOMIES ARE CONTROLLED BY FIVE-YEAR PLANS WHICH ARE FAIRLY ARBITRARY, I.E. PRIORITIES ON USE OF RESOURCES ARE ASSIGNED ADMINISTRATIVELY BY THE LEADERSHIP. ALSO AS IN THE SOVIET UNION, MILITARY PROGRAMS ARE ADMINISTERED WITH REFERENCE TO CLOSED SESSION POLICY DECISIONS AND ARE NOT PARTICULARLY RELATED TO DOMESTIC ECONOMIC UPS AND DOWNS. THERE IS NO INDICATION THAT CURRENT ECONOMIC FACTORS

WILL CAUSE ANY CHANGES IN THEIR MILITARY BUDGETS.

50. WE ANTICIPATE THAT SOVIET ECONOMIC INTER-RELATEDNESS WITH THE WEST WILL GROW BUT NOT ON A MAJOR SCALE; THIS FACTOR IS MORE IMPORTANT TO THE SOVIETS ECONOMICALLY THAN TO THE OVERALL WESTERN ECONOMY. IN CERTAIN SECTORS, HOWEVER, THE SOVIET UNION HAS A SIGNIFICANT ROLE AS A SUPPLIER TO THE WEST, FOR EXAMPLE, OIL AND NATURAL GAS.

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Message Attributes

Automatic Decaptioning: X
Capture Date: 18 AUG 1999
Channel Indicators: n/a
Current Classification: UNCLASSIFIED
Concepts: n/a
Control Number: n/a
Copy: SINGLE
Draft Date: 27 MAR 1975
Decaption Date: 01 JAN 1960
Decaption Note:
Disposition Action: RELEASED
Disposition Approved on Date:
Disposition Authority: CunninFX
Disposition Case Number: n/a
Disposition Comment: 25 YEAR REVIEW
Disposition Date: 28 MAY 2004
Disposition Event:
Disposition History: n/a
Disposition Reason:
Disposition Remarks:
Document Number: 1975NATO001703
Document Source: ADS
Document Unique ID: 00
Drafter: n/a
Enclosure: n/a
Executive Order: 11652 GDS
Errors: n/a
Film Number: n/a
From: NATO
Handling Restrictions: n/a
Image Path:
ISecure: 1
Legacy Key: link1975/newtext/t19750398/abbrzjam.tel
Line Count: 661
Locator: TEXT ON-LINE
Office: n/a
Original Classification: CONFIDENTIAL
Original Handling Restrictions: n/a
Original Previous Classification: n/a
Original Previous Handling Restrictions: n/a
Page Count: 13
Previous Channel Indicators:
Previous Classification: CONFIDENTIAL
Previous Handling Restrictions: n/a
Reference: USNATO 1647
Review Action: RELEASED, APPROVED
Review Authority: CunninFX
Review Comment: n/a
Review Content Flags:
Review Date: 16 APR 2003
Review Event:
Review Exemptions: n/a
Review History: RELEASED <16 APR 2003 by ShawDG>; APPROVED <23 SEP 2003 by CunninFX>
Review Markings:

Margaret P. Grafeld
Declassified/Released
US Department of State
EO Systematic Review
05 JUL 2006

Review Media Identifier:
Review Referrals: n/a
Review Release Date: n/a
Review Release Event: n/a
Review Transfer Date:
Review Withdrawn Fields: n/a
Secure: OPEN
Status: NATIVE
Subject: ECONADS: PAPER ON STRATEGIC AND POLITICAL IMPLICATIONS OF ECONOMIC SITUATION
TAGS: PFOR, ECON, NATO
To: STATE INFO ALL NATO CAPITALS
OECD PARIS
EC BRUSSELS
Type: TE
Markings: Margaret P. Grafeld Declassified/Released US Department of State EO Systematic Review 05 JUL 2006